

INCOME OR SALES TAX: WHICH IS THE BETTER OPTION?

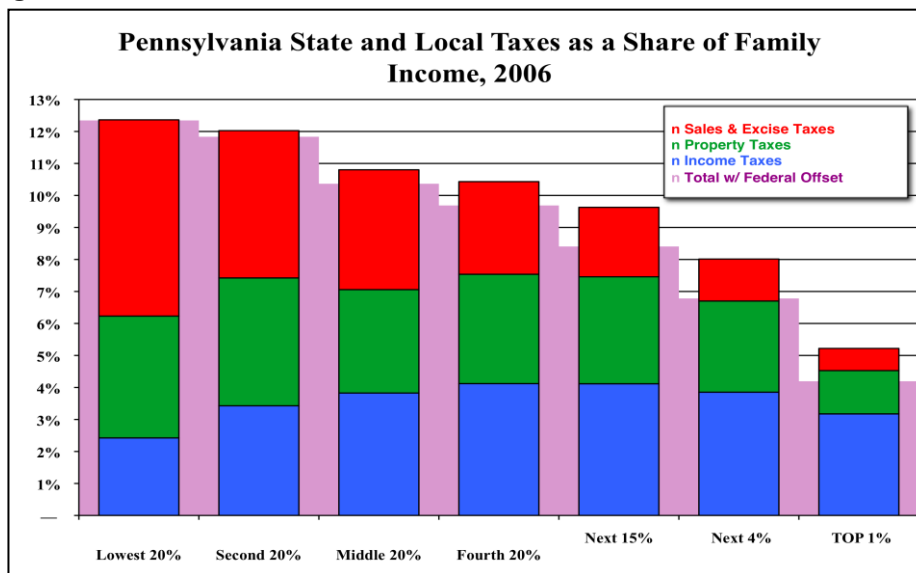
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The General Assembly is considering new revenue options to balance the Commonwealth's budget and fund higher education programs. A variety of revenue proposals may be considered in the coming days, including an increase in the personal income tax rate from 3.07% to 3.57% or a 1% sales tax rate increase. Both options would raise more than \$1.1 billion to prevent cuts in education, libraries, health care and services to vulnerable individuals. The sales tax may be a more popular option, but is it the right option for Pennsylvania?

Working families and seniors would pay more in a sales tax increase.

Because pensions and Social Security are not taxable in Pennsylvania, seniors would largely be unaffected by an income tax increase. Likewise, 22% of Pennsylvanians, predominantly working families with children and seniors, pay little or no income tax as a result of the Commonwealth's tax forgiveness program.

Figure 1.



Source: Institute on Taxation and Economic Policy

Figure 1 shows the share of income paid in state and local taxes for non-elderly taxpayers. The lowest 20% of earners pay more in sales taxes than higher-income earners. This is because a greater share of their income goes to consumption of taxable goods (represented by the red bars in Figure 1). Overall, lower- and middle-income families pay a larger portion of their income in all taxes than higher-income earners. A family earning \$65,700 would pay 10% of their earnings on state and local taxes after accounting for federal deductibility of income and property taxes, while a family in the top 1% pays only 4.3% after the same federal income tax deductions.

Businesses would pay 35%-40% of the sales tax increase.

It has been estimated that businesses pay up to 40% of all sales taxes (office equipment and supplies, fleet vehicles, etc.). Personal income tax would be levied only on the net profit of a business. Compared to all the income tax collected on wages, interest, and other income, business earnings are a much smaller share, less than 10% of the total. Whether a business is profitable or not, it has to pay sales tax. Even for those businesses that are profitable, their amount of taxable purchases often outweigh their ending profit.

Sales tax will dampen the economic recovery.

A direct sales tax on consumer goods is likely to dampen an economic recovery, as it makes goods more expensive to purchase. As prices rise, people and businesses are less likely to invest in new equipment or make

other big-ticket purchases. With unemployment rising and sluggish sales affecting most of the economy, a sales tax would not be a wise choice, hurting businesses, working families, and seniors.

Pennsylvania's income tax rate is second lowest in the nation.

At a flat 3.07%, Pennsylvania's top tax rate is significantly lower than our neighboring states and a better bargain for the highest-income families. Of the 43 states with a state income tax, only Illinois's rate is lower, at 3%. Even the effective income tax rates in Pennsylvania are low for the wealthy (see Figure 2 for a comparison with bordering states). The 0.5% rate increase proposed by the Governor would still make Pennsylvania's income tax rate the third lowest top rate in the country and allow Pennsylvania to keep its essential services.

Figure 2. Comparison of Effective Tax Rates, 2007ⁱ

Effective tax rates	\$50,740	\$100,000	\$500,000
Delaware	3.21%	4.50%	5.66%
Maryland	3.37%	4.05%	4.61%
New Jersey	1.42%	2.25%	5.42%
New York	3.15%	4.93%	6.65%
Ohio	2.20%	3.46%	5.72%
Pennsylvania	3.07%	3.07%	3.07%
West Virginia	3.43%	4.86%	6.17%

Pennsylvania's sales tax, however, is comparatively high, ranked at 12th in the nation. If the sales tax rate were increased by 1%, Pennsylvania would have the highest state sales tax rate in the U.S.ⁱⁱ Such a sales tax increase may spur Pennsylvania residents to purchase taxable goods out-of-state. This would be particularly likely in areas near Delaware (which imposes no sales tax) or Ohio (which has a 5.5% tax rate). Such cross-border sales would hurt Pennsylvania retailers and diminish tax collections – making the rate increase less effective in terms of revenue generation.

A federal deduction for state and local taxes benefits taxpayers.

Families may deduct state and local income taxes from their income subject to federal tax, reducing their federal income tax. Taxpayers who itemize deductions can receive as much as a 35% reduction in federal taxes for each dollar increase in state income taxes, reducing the net cost of the tax increase. No such deduction is available for Pennsylvanians regarding the sales tax.

The income tax best reflects people's ability to pay.

Since the personal income tax is based on just that, income, it is the best indicator of what people can pay. Other taxes like the sales tax are not based on ability to pay because they require low- and moderate-income taxpayers to devote a larger share of their incomes to paying taxes than upper-income taxpayers do.

The income tax is the fairest tax.

Since taxable consumption constitutes a larger share of income for low- and moderate-income taxpayers, higher-income taxpayers would pay proportionately less of their total income in a sales tax than low- and moderate-income taxpayers. As more working families experience layoffs, families' budgets become tighter, making it more difficult for them to pay for goods.

ⁱ Estimates are for a married couple with two dependent children using tax law as of 2007. In the wake of the recession, New Jersey has eliminated its property tax credit, which would result in higher effective tax rates than are shown. \$50,740 was the median household income, according to the U.S. Census.

ⁱⁱ At 7%, Pennsylvania would be tied with five other states (Indiana, Mississippi, New Jersey, Rhode Island, and Tennessee) for the highest state sales tax rate. Other states, notably New York and California, also impose local sales taxes that increase their total sales tax rates up to 8.435% and 7.25%, respectively. A 1% rate increase in Pennsylvania's state rate would also increase the overall rate in Allegheny and Philadelphia counties to 8%.